

United States
COURT OF APPEALS
for the Ninth Circuit

SAM SCHNITZER,

ESTATE OF HARRY J. WOLF, Deceased, by
Monte L. Wolf, Administrator, de bonis non
with the will annexed of said estate,

MONTE L. WOLF,

BLOSSOM M. GOLDSTEIN,

CHARLOTTE C. COHON,

ESTATE OF JENNIE WOLF, Deceased, by Monte
L. Wolf, Administrator de bonis non with the
will annexed of said estate,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONERS

On Appeal from the Tax Court of the United States.

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RESPONDENT'S POINT II. BUSINESS LOSS

We shall answer respondent's contention at page 51
of his brief first. He states:

"Furthermore, should this court hold, contrary to our contention in Point I, *Supra*, that debts did result from the advances, nevertheless they were not business debts and, hence, as provided by Section 23(k)(4) of the Code, are considered as a loss from the sale or exchange of a capital asset held for not more than six months and deductible only at the capital loss rates. (Sec. 117)"

As provided in Section 23, Internal Revenue Code, to be deductible a debt must become worthless within the taxable year. As to the question of worthlessness the court found (R. 51-2 and Resp. Br. 15-6):

"Immediately after the sale the purchasers elected new officers and directors, Mears becoming president. Pursuant to a resolution of the new directors and with the consent of RFC, the corporation gave to Morris, Sam and Rose Schnitzer and Harry J. and Jennie Wolf . . . its 6% note for \$151,000,

"By accepting the \$151,000 note in exchange for the two newly made promissory notes, the five former stockholders of Oregon Steel failed to recover \$303,625.90 of the total shown due from the corporation for their advances on open account, which at the time showed credit balances aggregating \$454,625.90. . . .

"Alaska Junk then charged off \$202,350.60 on its account with the corporation as a bad debt." Also see Exhibit 22, Minutes of Oregon Steel's directors' meeting November 26, 1943, and petitioners' Exhibit 20, cancelled note.)

It is, therefore, clear that the loss occurred in 1943 and was properly recorded in that year. Was it incurred in petitioners' business? Section 29.23(k)(6), Regula-

tion 111, provides in part:

“The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer’s trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is ‘incurred in trade or business’ under paragraph (1) of that section.”

The application of Section 23(k) is such that debts are allowable without limitation as deductions if they become worthless as a proximate incident to the business of the taxpayer. Obviously petitioners were engaged in business. The controverted transactions arose in the regular course of petitioners’ business, conducted through Alaska Junk (R. 42).

The last sentence of the second paragraph and the last paragraph of Section 29.23(k) reads:

“ . . . If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purposes of this section.

“To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the calendar year basis, extends credit on an open account to B in 1941.”

It will be noted the above provides that if the relation of the debt is “proximate” to the taxpayer’s business at the time the loss occurs it is not a non-business bad debt. Illustrations 1, 2 and 4 in the examples given un-

der Section 29.23(k) show that if the account receivable claimed as a bad debt is separated from the conduct of the creditor's business at the time it becomes worthless, the loss is not sustained as a proximate incident to the conduct of the business, while illustrations 3, 5 and 6 show that if the account remains associated with the business out of which it grew till it becomes worthless, the loss is a proximate incident of the conduct of the business, and hence is an allowable deduction as a bad debt.

It would be redundant to argue further that the loss is controversy was connected with petitioners' business or to cite cases illustrative of that point. The fact is patently obvious.

THE ISSUE

ANSWERING RESPONDENT'S ARGUMENT I A

Respondent's argument (Br. 21 et seq.) is that because the allowance of the questioned deduction is subject to legislative grant, petitioners must seek it "with prayer and supplication". No such aura of sanctity obscures petitioners' rights. It is true that all deductions depend upon "legislative grant", but that grant as to debts is explicit in the taxing act, and to establish their right to the allowance of the claimed loss petitioners are required to do no more than assume the burden of establishing the existence of the debt as a debt and that it became worthless in 1943.

Respondent laborious briefs this point, but none of his argument is applicable to the present controversy, for the rule he defends is one dealing with "statutory" construction. The cases he cites clearly show this. We are concerned here with a factual question. Did the advances create a "debt"? If they did, Section 23(k) says they "*shall* (must) be allowed as deductions" in computing net income. How could the legislative "grace" be more explicit?

Respondent is attempting to convert a rule of statutory construction into a rule for the interpretation of facts. This he may not do. The burden of proof in the case at bar is no different and is no more strict than in any other case.

In dealing with the question of a deduction for obsolescence, the Supreme Court in *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648 (1931), said:

" . . . It is a familiar rule that tax laws are to be liberally construed in favor of taxpayers. (Citing cases)

"It would be unreasonable and violate that canon of construction to put upon the taxpayer the burden of proving to a reasonable certainty the existence and amount of obsolescence. Such weight of evidence as would reasonably support a verdict for a plaintiff in an ordinary action for the recovery of money fairly may be deemed sufficient. . . ."

In *National Weeklies v. Commissioner*, 137 F. (2d) 39 (C.C.A. 8th, 1943), the court stated the rule as follows:

"When a taxpayer challenges the factual warrant for a deficiency assessment by the Commissioner, he must produce evidence before the Board of Tax Appeals which reasonably demonstrates that the Commissioner was wrong. *Burnet v. Houston*, 283 U.S. 223, 51 S. Ct. 413, 75 L. Ed. 991; *Lamaghi Coal Co. v. Helvering*, 8 Cir., 124 F. 2d 645; *Clements v. Commissioner*, 8 Cir., 88 F. 2d 791."

Many of the cases cited by the respondent used language speaking of legislative grant only as embellishment. In many of the other cases cited the *facts were stipulated* and this left for determination only the terms used in the taxing statutes.

In the present case there is no question whether the statute is susceptible of one meaning or another. Its meaning is clear. The tests for analyzing a particular set of facts to determine whether they come within the purview of the statute are also clear. The only question is with respect to the facts.

RESPONDENT'S POINT B. RECORD FACTS

Respondent asserts (Br. 25):

"Taxpayers' chief reliance is on the testimony of their witnesses at the hearing, especially Morris Schnitzer, that the shareholders never intended to invest more than \$187,800.00 in stock. . . ."

Such is not the case. Petitioners' brief fully sets forth the facts and circumstances upon which they rely, and among them are (Pet. Br. 11):

"Petitioners' Business Includes Making Advances as Loans."

Under this heading it is shown that, as found by the Tax Court, the advances in question were made in connection with a long established business practice followed by Alaska Junk in making such advances "in expectation of maintaining or increasing its trade" (R. 38); that Alaska Junk also made very large advances to enterprises in which petitioners' families were interested; that some of the advances were made as loans and some for the purchase of capital stock; that Alaska Junk always handled these transactions on its books of account as accounts receivable; that Alaska Junk in 1933 had sustained and had been allowed by the Commissioner a deduction on account of a loss from advances made to "a subsidiary", National Machinery Company (R. 198, 292, 360 and Exhibit 56); that the advances to Oregon Steel were made under identical circumstances and exactly in accordance with a practice which had been traditionally followed for thirty years; that there is no evidence of a departure from standard, orthodox practices in making or recording the advances to Oregon Steel; that Oregon Steel recognized the indebtedness and recorded Alaska Junk's vouchers for advances "in exactly the same manner as all other vouchers or invoices . . ." (R. 452). "All accounts (after entries for stock issued and debentures had been placed on the books) would be current and would be paid either out of RFC funds of operating profits." (Testimony Leon D. Margosian, certified public accountant, R. 258); that the account remained on the books of both the debtor and the creditor until it was compromised and settled in November, 1943, by the issuance of a third mortgage

note; that the settlement with both creditors, Alaska Junk and Morris Schnitzer, was made upon the basis of the indebtedness of Oregon Steel as shown by its open account payable to the respective parties, and not in proportion to the amount of stock held by each.

All of these facts clearly and affirmatively reflect the existence of the debtor-creditor relationship, and neither the trial court nor respondent pointed to a single affirmative, positive, evidentiary fact which indicates any other intention on the part of the petitioners of Oregon Steel.

Under point II, 2 (Br. 23-28) petitioners also showed that the evidentiary facts as found by the Tax Court require the ultimate finding the advances were intended to and did create the debtor-creditor relationship.

Petitioners further showed (Br. 28-38) that, contrary to the Tax Court's views, the documentary evidence relied upon as a basis for its adverse inferences does not support the inferences that were adopted.

Point 1 (Resp. Br. 27)

The rule urged by respondents that the mere naming of a thing is not conclusive, is a true one. However, all of the circumstances, including the name applied, are to be considered in making the determination. It is to be noted that taxpayers were consistent in the naming.

The Tax Court found that the refusal of taxpayers to *invest* more than \$250,000 (a fortiori \$187,000) was the cause of their difficulty in securing outside financing

(R. 65). Had they had any *intention* of ever increasing the invested capital it would have been to their greatest advantage to have done so then, but they did not. They steadfastly refused to ever increase either the *authorized* or the *invested* capital, preferring to meet the obligations by advances continuously characterized as loans.

The reasons for their refusal were adequately explained by Morris Schnitzer. He promoted the project (R. 87). He wanted to keep control (R. 83). If the subscribed capital had been increased he would have lost control.

The Tax Court and respondent make much of the fact that the advances made were used for investment in corporate organization and plant, and by "their very nature (were) placed at the risk of the business". Surely, it cannot be seriously contended that the use of the money has any effect upon the nature of the advance. All of the funds from RFC, bank loans and \$190,000.00 advanced by outside creditors, were used for organization and plant, but that fact does not alter the character of the advances by these creditors.

Point 2 (Resp. Br. 27)

Respondent undertakes to brush aside as meaningless petitioners' practice of charging advances to debtors as "accounts receivable", notwithstanding the fact the practice had been followed for thirty years. And in spite of the fact they represent and are in accordance with the standard, orthodox practice of handling such trans-

actions. The fact the charges were in three categories in no way changes the legal effect of the debtor's obligation. They were all charges to the vendee, and nothing would have been added by making charges to three separate accounts receivable.

Point 3 (Resp. Br. 28)

Respondent raises the point that no interest was charged and no written evidence of indebtedness was issued to cover the advances. This might be a significant fact, except for two things. While interest and formal written evidence of indebtedness are indicia of indebtedness, it cannot be argued that a debt does not exist or is not a debt simply because interest is not charged or accrued, or that no evidence of indebtedness was issued. Further, this was not an isolated transaction. It was one of many similar transactions wherein taxpayer made advances to various enterprises (R. 38-40). There is not one scintilla of evidence of interest ever having been charged in any of those transactions, except Hesse Ersted Company (R. 236). No question has ever been raised as to the intent of the parties in those transactions to create a debt and from the evidence we can but deduce that the surrounding facts were identical; no interest charge, no written evidence of indebtedness except the open book account, no date certain for payment, etc. Petitioners were engaged in the business of making loans, but were not so engaged for a direct profit on the loan. Their purpose was to create good will, to help in starting new businesses as prospective customers of

their business, and to encourage new or growing present customers to trade or continue to trade with them. It is significant that these previous loans were repaid by supplying merchandise and scrap, and seldom in cash (R. 234-238, 302-308).

Point 4 (Resp. Br. 29)

Respondent complains that no notes except those dated November 26, 1943, were given.

(a) It is well known that in trade it is not the practice to execute notes for trade accounts, and it is axiomatic that this is not necessary to create an indebtedness.

(b) Nor is corporate action necessary in ordinary, everyday business transactions, such as those involved here, in order to create a subsisting liability. As early as 1924 the Board of Tax Appeals (now Tax Court) held in the appeal of *Rube Isaac & Co.*, 1 B.T.A. 45, that closely held corporations act very much like partnerships and that any acts of the corporation

“ . . . pursuant to oral understanding are as binding as though sanctified by the most rigid adherence to legal formality, . . . (Citing cases.”

Nor is it necessary to fix an absolute date of maturity. However, in the instant case, as testified by Leon Margosian

“I was instructed . . . all other accounts would be current and would be paid either out of RFC funds or operating profits.” (R. 453)

The accounts were to be repaid currently.

Point 5 (Resp. Br. 29)

Here respondent dwells upon what he terms a strict rule of construction. Petitioners are well aware, as has been set out above, that they must show that a debt existed and that it became worthless, but Congress has specifically provided for the deduction of all losses resulting from debts becoming worthless, and the degree of proof required here is no greater than that required with respect to such items as interest, expenses, depreciation, taxes and any other such items provided for in the revenue act. This is a "business deduction", and the transactions that are the subject matter of the loss were ordinary and necessary business transactions. Therefore, they must be viewed in that light. To require more would be to place an unnecessary burden and penalty upon legitimate business operations. These debts were created out of profit producing transactions entered into at arms length, including the sale of merchandise at the regular going prices to the trade, and petitioners have paid Federal incomes taxes upon the profits made from said transactions. It would be a harsh rule indeed for the government to apply one standard of construction against a taxpayer in obtaining taxable profit upon such transactions, and to apply a stricter standard in depriving the same taxpayer of the loss sustained in connection with the identical transactions.

The chronological sequence of events set forth by respondent is very helpful and significant. He continually talks of ambiguities of taxpayers' dealings, but it

should be apparent to this court that far from being ambiguous they are consistently and clearly indicative of the intent to create a debt. *Certificate of Contributions Of Capital* (Ex. Q), clearly shows intent to create a debt. Respondent makes much of the words "contributed capital" but his argument shows a complete lack of careful analysis. While vigorously urging the rule that parties cannot rely on words of art for their technical meaning, but must look to legal effect, he completely ignores his own warnings. The certificate states Petitioners *had* (note the use of the past tense) "contributed capital" of \$299,069.70, and that Morris Schnitzer *had* "contributed capital" of \$138,984.11, and, most significantly, continues:

" . . . that there will be issued to such contributors, . . . common stock in said corporation at par in the sum of \$187,700, *and the balance* in the debentures of said corporation. . . ." (Italics supplied)

Respondent asks this court to infer Morris Schnitzer, by use of the words "contributed capital", is inconsistent with his testimony the parties did not intend to invest more than \$187,700. A careful reading clearly shows that Morris Schnitzer included in "contributed capital" both investment and debt, and the ordinary meaning of the words "contributed capital" must be tempered by their obvious use to embrace both investment and debt, as is clearly set forth in the body of the instrument. Contrary to respondent's attempt to use this exhibit to impeach Morris Schnitzer's testimony as to intent, it, in fact, substantiates it.

The significance of the balance of the instrument was to reassure RFC its loan would at all times be paramount to all advances made by the incorporators.

Exhibit R referred to by respondent is in the same terminology and by its terms it, too, specifically defines "contributed capital" and the phrase "contributed as capital investment" as including investment and debt. Thus, again, no significance to the terms can be given outside the obvious meaning contained in the entire instruments.

Counsel's attempt to minimize the importance of the actual repayment by RFC of \$114,519 on the debt emphasizes the significance of the fact. An actual repayment of \$114,519 on the total debt was made. The fact stands as a beacon light.

Counsel (Br. 14) would regard as significant the fact at the time debentures were issued, they were not issued for the full amount of the open account outstanding. The simple fact is, a debt is a debt. The issuance of debentures would not change an investment into a debt. No allocation of this open account was needed. A debt without security is nonetheless a debt, and counsel's shock at a failure to take debentures for the balance of the account did not change its essential character as a debt.

In counsel's speculation as to Petitioners' intent to withhold any designation of the advances awaiting their best advantage (Br. 41) he is laboring without benefit of evidence.

Every act and deed, every word spoken or written prior to the collapse of Oregon Steel indicates an abiding intention to regard these advances over the amount of the authorized capital as debt. There are only failing inferences to the contrary. Petitioners steadfastly refused to convert their loans to investment, notwithstanding the refusal of Commercial Credit Corporation, Bank of America, Bank of Portland and New York Investment houses to advance capital unless they did so (R. 43). These are "record facts" and not testimony given five years after the transactions.

It is difficult to see how counsel or the Tax Court could find any intent other than to create a debt in view of these facts. One's declaration as to a fact made at a time when his then best interest lies contrary to such a declaration is one that simply cannot be overcome.

Counsel's Point 6 (Br. 43) is fully answered in Petitioners' brief, pages 42-45.

PETITIONERS MUST SHOW THAT TRIER'S FINDING WAS ERRONEOUS

As to respondent's argument that petitioners must show the trial court's findings that the advances did not create a debt is "clearly erroneous", petitioners assume that burden. The problem is: When is a finding "clearly erroneous?" We have it on the highest authority, *United States v. U. S. Gypsum Company*, 333 U.S. 364 (1948), that a finding is clearly erroneous when, although there is evidence to support it, on the *entire record* the re-

viewing court is left with the firm conviction a mistake has been committed. Neither the Tax Court nor respondent points to a single cogent, convincing fact upon which to bottom the inferences leading to the court's ultimate findings or conclusions, and *this court need not go outside of the trial court's own detailed evidentiary findings to discover the error it committed*. The primary facts found contain all essential elements of a debtor-creditor relationship, and the court points to no affirmative, positive, unorthodox act connected with the condemned transactions, even in the light of the most rigid income tax standards, which, upon impartial analysis, shows any thought or intention by petitioners to treat the advances other than as accounts receivable which they expected to be repaid.

The debtor-creditor relationship does not depend upon fixed indicia, such as notes, interest, corporate action authorizing purchase of merchandise or receipt of advances, but depends upon normal indicia applicable to individual situations.

The court's inferences are strained, illogical and do not conform to a natural, rational interpretation applicable to regular, standard, orthodox business transactions. The essential question is whether the debtor-creditor relationship was created by the sales of merchandise and the advances made to Oregon Steel. The evidence is clear that not only petitioners but Oregon Steel intended to create a debt.

Regarding respondent's reference to corporate liabilities, capital stock, use of the funds, adequacy of cor-

porate capital, payment of interest, payment of advances from corporate profits, etc., none of these conditions is determinative of the question, none is recognized by the courts as determinative criteria, but as petitioners point out, page 45-49 of their brief, the SOLE criterion followed in the cases is the "intent of the parties", and only insofar as relevant facts bear upon that point are they of help in determining the issue. Respondent seeks to draw the attention of the court away from the primary facts. We have a clear statement of the evidentiary facts upon which to ground the ultimate findings. The court forsakes the preponderant facts and magnifies insignificant circumstances considered as rebutting them.

On the question of when findings are "clearly erroneous" Judge Orr struck at the heart of the problem in *Wilshire and Western Sandwiches, Inc. v. Commissioner*, 175 F. (2d) 718, in the following language:

"Petitioner asserts that the transactions under consideration here have few of the characteristics of the people dealing at arms length. Whatever view may be taken as to the number of those characteristics, the *controlling fact remains* that those which appear are the essentials of a bona fide transaction. In reaching this conclusion we think we are dealing with substance and reality and not mere form, a requirement in the field of taxation." (Italics supplied)

Whatever inference may have been drawn by the trial court the "controlling facts" here are that for thirty years petitioners had been engaged in a business which included making advances to other persons for "maintaining or increasing its trade"; in June, 1941 more than

four months before any advances were made to Oregon Steel petitioners fixed the amount of stock they intended to subscribe; the books of all parties *consistently* recorded the advances under a debtor-creditor classification; these accounts remained as originally entered until the obligations were compromised and written off as bad debts.

While it is true Rule 52 FRCP contemplates that in appraising oral testimony the appeal court must give "due regard . . . to the opportunity of the trial court to judge of the credibility of the witnesses", nevertheless, as stated by this court in *Grace Bros., Inc. v. Commissioner*, 173 F. (2d) 173, "it is axiomatic that uncontradicted testimony must be followed" and there is no exception to this rule unless the witnesses stand impeached and the impeachment is conjoined with contradictory testimony, physical facts *actually proved*, or the testimony is inherently improbable. It is noteworthy that respondent does not attempt to show that the testimony of petitioners' witnesses was contradicted by other testimony, or "by facts actually proved", but he mildly suggests (Br. 26):

"The Tax Court did not err in declining to accept testimony . . . which in the light of the entire record *might reasonably be regarded* as inherently improbable." (Italics supplied)

This falls far short of justifying the Tax Court in arbitrarily disregarding this uncontradicted testimony, and constitutes plain error, as is so aptly expressed in *Lawton v. Commissioner*, 164 F. (2d) 380 (C.C.A. 6th,

1947), and *Grace Bros., Inc. v. Commissioner*, 173 F. (2d) 170 (C.C.A. 9th, 1949). This rule is not relaxed by the fact the witnesses were friendly. Perjury is perjury and truth is truth, whether from the lips of friendly or adverse witnesses.

Such cases as *Aetna Life Insurance Co. v. Kepler*, 116 F. (2d) 1 (C.C.A. 8th, 1941), quoting William D. Mitchell, Chairman of Advisory Committee for revision of FRCP; *Fleming v. Palmer*, 123 F. (2d) 749 (C.C.A. 1st, 1941); *Murray v. Noblesville Milling Co.*, 131 F. (2d) 470, 474 (C.C.A. 7th, 1942); *Presidio Mining Co. v. Overton*, 270 Fed. 388 (C.C.A. 9th, 1921), are authority for the rule that if ultimate findings by the trier are contrary to the clear weight of evidence or the preponderance of the evidence they are clearly erroneous.

The evidentiary facts found by the court meet the requirement laid down by *Lawton v. Commissioner*, *supra*, in that they "lend a flavor of truthfulness to their assertions". Consequently, this testimony may not be disregarded but "*must be followed*".

THE DOCTRINE OF STARE DECISIS

In *Wilshire & Western Sandwiches, Inc. v. Commissioner*, *supra*, and *Maloney v. Spencer*, 172 Fed. (2d) 638, the court has held that "intent" of the parties with respect to transactions such as those involved in this appeal is controlling. To decide otherwise in this case would be contrary to that rule.

See *Jorgensen v. Swope*, 114 F. (2d) 988 (C.C.A. 9th, 1940), in which the trial court followed its previous decision in *Cooke v. Swope*, and stated:

“ . . . The decision of the trial judge in *Cooke v. Swope, supra*, was sustained by this court. 9 Cir., 109 F. 2d 955. Our decision in that case should be followed unless there is some controlling distinction or some subsequent decision by the Supreme Court requiring us to depart therefrom. There are none.”

Also in *Papani v. United States*, 84 F. (2d) 160 (C.C.A. 9th, 1936), unlawful search was involved and this court said:

“ . . . However, this court has determined that such statements are not always conclusive, but must be considered with the other actions of the officers, and the surrounding circumstances (Citing cases). Such rule, under the doctrine of stare decisis, is controlling with respect to this court.”

CONCLUSION

The Tax Court's decisions were clearly erroneous and should be reversed.

Respectfully submitted,

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